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By John Mauldin

Be careful what you wish for. You just might get it. This week we look at a more transparent Fed, Japanese monetary policy, the powerhouse rise of gold, and a rather important op-ed piece in the *Wall Street Journal,* with a theme of seeing how they all impact the dollar. There is more than a little intrigue in the markets, and we try and make sense of it. We are going to quote a number of friends who each give us a piece of the puzzle, and see what it all means. But I'll give you a preview: it means more volatility and a weaker dollar.

I'll Be Watching You

But first, let's have some fun. The following is a link to a very funny satirical music video by the students at the Columbia Business School (first sent to me by Gary North among a host of friends). This takes a little set-up to understand some of the inside jokes. It is set to the tune of the old Police hit, "Every Breath You Take." It makes fun of the fact that the Dean of the Business School, Glenn Hubbard, former chairman of the Council of Economic Advisers to the President, wanted to be Fed chairman. CBS refers to Columbia Business School and not the TV network. Major kudos to the kids who did this! And for those of you who aren't familiar with Hubbard's face (after all, he is an economist), the student who "plays" Hubbard is an uncanny look-alike of a young Hubbard. At least now, Glenn, you can make claims to being an erstwhile rock star.

Sample lyrics, as "Hubbard" sings about Bernanke:

"First you move your lips, and hike a few more bips, when demand then dips and the yield curve flips, I'll be watching you!" Crank up the volume and enjoy!

http://www0.gsb.columbia.edu/students/organizations/follies/media/EveryBreath.wmv

To Pause, or Not To Pause

And that sets up our first item of the day. Fed chairman Ben Bernanke rather shocked the markets yesterday. Let's go straight to the quote that sent waves through the foreign currency markets:

"… if in the Committee's judgment the risks to its objectives are not entirely balanced, at some point in the future the Committee may decide to take no action at one or more meetings in the interest of allowing more time to receive information relevant to the outlook.... Of course, a decision to take no action at a particular meeting does not preclude actions at subsequent meetings."

Bernanke is on the record as calling for a more transparent Fed. He is clearly signaling a subtle but important change in Fed policy. Heretofore, the Fed meets, raises rates 25 basis points, and goes home. They are highly likely to do so at the Fed meeting in early May.

Bernanke as much as guaranteed that the statement from that meeting will change as well. Instead of promising an interest rate hike at the next meeting, it is likely to leave open the possibility that the Fed will pause or stop or raise at the next meeting in June. Anything could happen.

The Fed is nearing the end of its interest rate hike cycle. **But I think it is clear from reading the speeches of the various Fed governors that they do not now know when that will be.** We are in new territory. Thus, they are going to become data-driven from meeting to meeting. Interest rate policy is going to be set by the data that comes out between meetings.

They will be looking at inflation, the housing market, consumer spending, overall growth, and a lot more. I have said for a long time that until the housing market slows down, the Fed is likely to continue to raise rates. There are some data-driven as well as anecdotal signs that may (finally!) be happening. If housing is slowing down by the June meeting, they may indeed decide to pause and see what the summer brings.

Today we learned that the economy grew 4.8% in the first quarter of this year. That is really quite strong. Inflation is at the upper end of the Fed's comfort level. If we see another two months of that type of environment, it is likely they will raise rates yet again, at least in August.

But there is reason to think they may raise again in June. If the inflation data continues to be high, the Fed committee may agree with former Atlanta Fed president William Ford, who commented on Bernanke's testimony about the interest rate outlook and inflation:

"It surprised me that he was as soft as he was in the way he couched the outlook for future change. No matter what inflation rate you look at, including the one they look at, inflation is at the upper end of a tolerable band in their measures, and certainly for those of us that eat and use energy, which is the real CPI, is up by over 3 percent year-over-year… *So I expected him to be a little bit tougher than he was, and the market also expected that and reacted appropriately to his suggestion that they might take a rest when we get to the June 28-29 meeting after the May 10 meeting.*" (Courtesy Bill King)

Frankly, I think pausing in June would be a good thing. I think the economy is likely to slow in the latter part of the year and that inflation will take care of itself, without the Fed "piling on" with yet one more rate hike. If I am wrong, then they can always catch up during the remainder of the year.

But hold a gun to my head and ask me today? I still think the odds are for more rate hikes, as the economy is doing well. Is it going to roll over in 50 days? It sure does not seem that way now.

Rising Volatility, Falling Markets

But this means that the markets are likely to become more volatile, as each piece of "data" will become more important the closer we get to a Fed meeting, potentially moving the markets with a sudden swiftness. And rising volatility in the current market climate is not necessarily a good thing. In next week's Outside the Box, I am going to be sending you a very important study done by good friend Ed Easterling at Crestmont Research. He discusses how volatility, in terms of historical trends, is actually at the low end of the scale, which means that it can only go up from here. Rising volatility in the secular cycles we are in today is not good for the stock market. This will be out Monday night. **I strongly suggest you set aside some time to read it**. Let me give you a preview:

"It seems that never before have the bulls and the bears had such strong arguments—the tectonic plates of the markets are intensely balanced in an edgy state of latent eruption. Most investors are actively searching for clues about what might next occur in the stock market: new highs or a correction.

"Regardless of the direction of the market's next leg, the move is likely to happen with increased volatility. The historical cycle of stock market volatility has been erratic, yet consistent, for more than five decades. And although the trend in volatility may not be a completely reliable indicator, it does offer key insights about the likely direction of the market. Most if all, portfolios that are best positioned for declining volatility often do not perform well in rising volatility. Therefore all investors can directly benefit from insights about the upcoming conditions.

"… The current state of volatility is an indicator of a potentially sharp stock market decline based upon (i) the currently low level of volatility, (ii) the tendency for upward spikes to follow extreme low volatility, (iii) the relationship of market direction to volatility trends, and (iv) the propensity for downside volatility during secular bear markets. Volatility could decline further and could remain low for some time longer; however, based upon history, it has not stayed low without subsequently spiking and, as it goes lower, the likelihood of a spike increases significantly.

"When volatility does start to rise and the stock market likely declines, the bulls will call it a "pullback" or a "correction" in advance of the next major upward move in the market. Because we are currently in a secular bear market (at the least, a bear-in-hibernation), the market can be expected to act as it has during the past secular bear

markets. Keep in mind: over the course of secular cycles, the market is driven by recognized principles of economics and finance. The current market conditions are not positioned to provide another secular bull market at this time—it is not a sleeping bull. The current conditions reflect a secular bear or a bear-in-hibernation because the price/earnings ratio ("P/E") is above its historical average. Without a rising P/E, future returns will be below average and investors are likely to experience an extended, choppy, and often volatile period."

G7 to Asia: Stop the Currency Manipulation

And there are other reasons to think volatility may be rising. First, let's look at the rather surprising communiqué that came from last weekend's G7 meeting. Normally, these are the most bland of any government release. But this one had some bite to it. The best way to look at it is from trading maven Dennis Gartman's viewpoint:

"One gets the sense that the market and her participants are taking stock of the situation; are re-reading and re-considering what it was that the G7 was trying to tell the markets in broad terms this past weekend, and are considering what messages the IMF and other international banking organizations are trying to send. The more we consider these things the more convinced we are that the G7's communiqué this past weekend is preparing us for something along the lines, eventually, of another Plaza Accord-like notice at some point in the future. It was a shot across the bow of the economic policies of China. It was a warning shot to Japan … and these 'shots' were fully intended, carefully planned and completely understood.

"We turn then to what our good friend, Mr. Robert Savage of Goldman Sach's foreign-exchange dealing operation, said in his always insightful evening commentary yesterday regarding what is going on in the forex market. He said:

" 'The G7 opened the box of conspiracy theories [this past weekend]. Today's FT article on the IMF role in FX is a case study in how international cooperation can be less than clear and can lead to even less clarity. The story highlights how the G7 communiqué means different things to different nations—to the ECB's Trichet it's all about the 'scary' US current account deficit; to Japan it's all about the need to revalue the CNY; to the US it's all about stoking domestic demand in Europe and Japan. **But in the end—the language agreed upon opens a door to traders to sell the USD.**

" 'Everyone realizes that the acceptance of big intervention to hold the USD bid or of pegged currencies to enhance trade has been cut and a line has been drawn. Further—talk about the IMF role draws out the need for reserve management—and how much of the EUR or gold to hold instead of the USD comes into play. Further—as the US gets news that shows a Fed policy of "pause" in the face of stronger consumer demand fed by a strong jobs environment—then inflation returns as a concern.'

"Mr. Savage is absolutely right in what he's said. The fear of intervention to stem dollar weakness has been all but withdrawn. The Ministry of Finance in Japan

intervention efforts shall only be realized should the Yen/dollar rate become unstable or far too abnormally volatile. We suspect that that means only should the Yen/dollar rate move 3 Yen or more in a session will the Ministry make its anger felt via intervention. Too, the communiqué made it clear that the G7 expects China to move more rapidly toward strengthening its currency, to the detriment of the Yen's present advantage, which means a stronger Yen vs. the US dollar as the Renminbi/Yen rate will be expected at least to hold steady even as the Yen strengthens vis a vis 'the buck.'"

I have been bearish on the dollar and bullish on gold for four years. I have often noted that the drop in the dollar would hopefully take a long time and be done on a gradual basis. It appears we are getting ready to see another leg down in the dollar, and this time maybe against the Asian currencies as well. Let us hope that this next leg down is long and slow.

Good friend Chuck Butler must be happy. He runs the foreign currency desk at Everbank. You can get an FDIC-insured CD denominated in almost any currency you want. If you are interested you can reach him at 800-926-4922, and tell him I said to call.

A Brief Historical Reminder

Ok, let's now look at another piece of the puzzle, courtesy of my friends at GaveKal. As I wrote a few weeks ago, the change in monetary policy in Japan has the potential to be a very big deal indeed. They have been the source of much of the massive build-up of liquidity in the world's collective money supply. Let's let GaveKal take us down memory lane to see exactly how much:

"A few years ago, as Japan remained stuck in its deflationary bust, most cognoscenti were happy to pronounce that Japan had become "irrelevant"; and sure enough, most investors stopped paying attention to what Japanese policy makers were really up to.

"Meanwhile, faced with a collapse in the domestic velocity of money, Japan's policy makers were about to adopt a set of policy which would influence asset prices all over the world and whose repercussions are still felt today. The reason behind the collapse in the velocity of money was easy enough to diagnose: Japan's commercial banks were, by and large, bankrupt. This left Japan's policy makers with two options:

A) Nationalize and recapitalize the bankrupt commercial banks (a course of action which most policy makers felt was too politically contentious) or

B) Flood the system with high powered money, so that the collapse in V would be compensated by the rise in M so that P*Q (i.e.: nominal GDP) could stabilize (as per Irving Fisher's MV=PQ).

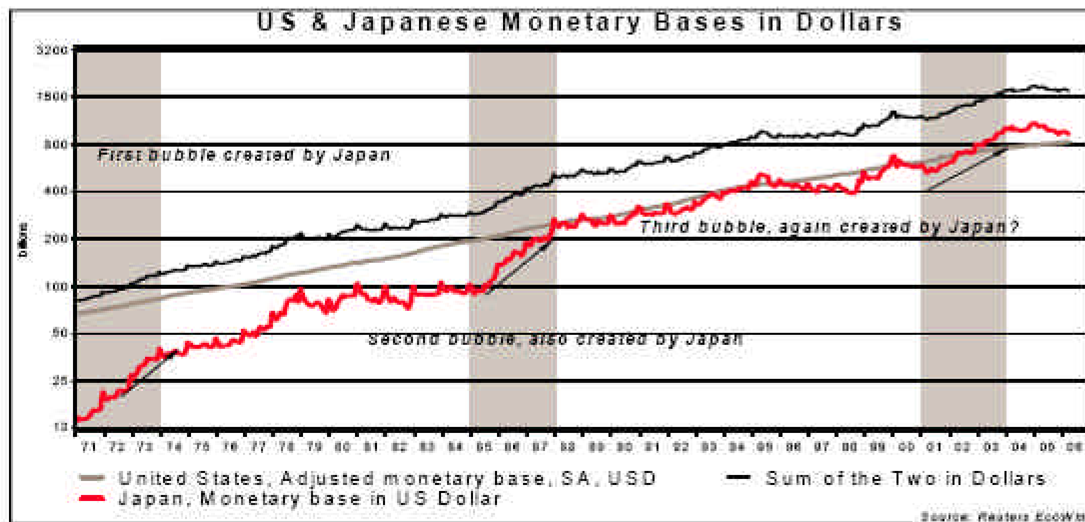
"And the policy of quantitative easing (QE) was born. This policy of QE came on top of other policies already implemented, namely the zero interest rate policy (ZIRP)

and a policy of control of the exchange rate in a band of ¥105-¥120 against the US$. And together, these policies would have a massive impact on global financial markets.

Japan Dumps Money into the System – QE

"One of the trademarks of perma-bears is to blame all the world's ills on an hyper-active Fed whose policy shifts endanger the state of our economies and the value of financial assets. But is this a fair indictment? Judging Fed policy by the growth rate of the US monetary base (see chart next page), we find that the US monetary base has been growing fairly steadily and in line with US GDP growth. In fact, if one wants to blame a central bank for volatility in global monetary aggregates, one should instead turn to Japan.

"The chart below shows the US monetary base, the Japanese monetary base – in dollars – and the sum of the two (also in dollars). What emerges from this graph is very simple: all the volatility in the US + Japanese base aggregate has come from the Japanese part of the component. The volatility in global M has in the past thirty years come from Japan.



"Looking at the past thirty-five years, we find that the Japanese monetary base has been allowed to double over short periods (i.e.: less than three years) three times. Each time, it led to massive bull markets (real estate, share prices, commodities, gold, etc…), followed, some time after the expansion of Japan's money supply was over, by a serious market downturn. Will this time prove any different? **So far, it has!**

"Another interesting fact drawn from the above chart is that, following the large 2001-2004 expansion in the Japanese monetary base, the Japanese monetary base is now larger than the US'. That is quite impressive for an economy less than half the size."

"So far, it has!" That sounds to me like the old joke of the man who jumped off the top of the Empire State Building, and commented as he flew past the 52nd floor, "So far, so good."

Japan has made it clear they expect the policy of quantitative easing to stop and, at some point in the future, we will actually see Japanese rates rise. This is going to have a large effect on world interest rates and liquidity, maybe as much or more than the Fed raising rates.

Couple this with the Chinese move to raise rates, which I think is just the first in a series of things the People's Bank of China will do to slow down certain sectors of the Chinese economy. They will also continue to slowly allow the Renminbi to rise, and maybe even at a faster rate if the rest of Asia will go along as the G7 suggests.

The Dollar at Home – and Abroad

Just how serious is all this? In 1992, I remember reading a watershed op-ed piece in the *Wall Street Journal* by Walter Wriston, former chairman of Citibank and the ultimate insider. Basically, he waved the white flag and said in essence, "Central banks and governments can no longer control currency valuations. It is now in the hands of traders and hedge funds." From time to time, you see such op-eds in the *Wall Street Journal* and think, "This might be important."

This Friday gave us another important essay. This one is by Martin Feldstein, Harvard professor, chief economic advisor to Ronald Reagan, and a host of other titles and honors. He was on the very short list of two or three names to be appointed Fed chairman after Greenspan. When he speaks, American policy makers pay attention. If you can get last Friday's *Journal,* I suggest you read the entire article (page A-14). Here are some brief excerpts [emphasis mine]:

"For more than a decade, under Democrats *and* Republicans, Washington has emphasized that 'a strong dollar is good for America.' **It's time to change the message. We need a strong dollar at home and a competitive dollar abroad: i.e., an exchange rate that will make American goods more attractive to foreign buyers and that will cause American consumers and firms to choose American-made goods and services.**

"… These two goals – strong at home, competitive internationally – are compatible in practice. With an appropriate monetary policy, we can shift to a competitive level of the dollar without raising the future rate of inflation. Consider what happened in the '80s, the last time that the dollar fell sharply. In April 1985 the dollar began a decline, falling 23% in 12 months and a total of 37% by the beginning of 1988. Although the price of imports rose sharply, the overall inflation rate did not increase. CPI inflation, 3.9% in 1984 (and almost exactly the same in the previous two years), actually declined to 3.8% in 1985 and to 1.1% in 1986. Between 1985 and the start of 1988, while the dollar fell 37%, the inflation rate averaged only 3.1%. Although a decline in oil prices contributed to this lower rate of inflation, the core rate of inflation

that excludes energy prices also fell. That's not a guarantee that a dollar decline now wouldn't raise inflation, but it shows that it is possible to have a sharp dollar decline with no adverse effect on inflation.

"… **But the primary reason for wanting the dollar to become more competitive in the near future is that we may need an improved trade balance over the next few years to sustain the economy's expansion.** Although forecasters generally believe that the likely outlook for the economy in 2006 and 2007 is a continuation of solid economic growth, there is a serious risk that the combination of falling house values and an end to the low-interest incentive to refinance mortgages will cause consumer spending to decline relative to incomes. A sharp slowdown in consumer spending could cause an economic downturn.

"… **Even if the dollar does decline during the coming months, the delays in the response of exports and imports to the more competitive dollar will mean that the increase in aggregate demand from this source may not happen for a year or more. That's why the U.S. needs to shift to a more competitive dollar as soon as possible.**"

Feldstein is only acknowledging what everyone knows. The dollar must fall over time as part of the process to balance the trade deficit. The imbalance can go on for a lot longer than most dollar bears think, but not indefinitely. Better to start the process now and have it go slow and, if not actually smoothly, then not precipitously. Feldstein is giving intellectual cover for a policy everyone knows will be implemented, whether actively with worldwide cooperation or forced more violently by the markets.

What the G7 communiqué, the announcements by Japan, statements by European central bankers, and the Feldstein piece all add up to is a call for a weaker dollar to deal with the perceived problem of the US trade deficit over time. I expect there will be some serious back-room discussions trying to get cooperation from the various Asian nations to allow their collective currencies to rise.

The last decade has seen a period of competitive currency valuations among the Asian countries, as each tried to maintain whatever competitive advantage it could muster through currency manipulation. Thus, we see the massive buildups of their balance sheets, which are mostly invested in US dollar-denominated debt of some form.

That currency regime may be in the process of changing. Someone send a note to Senators Schumer and Graham, brothers in bipartisan idiocy, that you should be careful what you wish for, as you may get it. We may indeed get a lower dollar, but it will come with a price. I rather suspect that the transition will not be as smooth as one would like. It will be a period of slower growth and Muddle Through. Enjoy the recent good times while they last. Not that they won't come again, but the period in between will be slower and bumpier.

Mac Ross, Rest In Peace

It is with heavy heart that I note the passing of my dear friend Mac Ross, who succumbed last night after a long, valiant, and dreadfully difficult battle with pancreatic cancer. Mac was always a source of wisdom and candid comments. In addition to being a close and true friend, he was the smartest marketing mind I have ever met. We first met when he worked for Phillips Publishing in the early '80s, and he has consulted with a number of people in the investment publishing world. I called upon his remarkable talents frequently. Truth is, he came up with the name for Bull's Eye Investing, as whatever I was going to call it before didn't pass muster with him. And a lot of "my" best ideas were hatched in conversations with Mac, often with a glass of wine (he was a true connoisseur) and long, rambling, but very insightful discussions.

Mac had great character and integrity. We would do six-figure business deals on a handshake, and I would never worry that he woud keep up his end of the bargain.I always enjoyed staying with Mac and his wife Marji (brilliant in her own right) on my trips to DC, as it meant a night of great conversation, great wines, and good friends. A voracious reader, he had well-thought-out opinions on just about everything, and freely shared his sources, ideas, and opinions with one and all. He was a gentle, happy, passionate man and I will miss him terribly, as will all his friends, but especially his wife Marji and their three daughters, 16, 14, and 9. (Many of you will either know or know of Marji, as she is the president and publisher of Regnery Books.) All of us wish her and the children the very best and offer our deepest sympathies and any help we can. Rest in Peace, Mac. (Marji requests that donations be sent to the Lombardi Cancer Center at Georgetown Hospital. There will be a memorial service on Tuesday.)

Orlando, Montreal, and La Jolla

I will be here next week for a quick day and speech, then in Montreal the following week. Then on to La Jolla for my Strategic Investment Conference. It will make for a busy month, but it should be (mostly) fun.

It is time to hit the send button. It will be a reflective weekend for many of us. Life is so easily and too quickly shed, it seems this evening, and we need to spend more time with family and friends, as they are the true wealth in our lives. Have a great week.

Your thinking life is too short analyst,

John Mauldin